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IN THE

Supreme Court of the United States

October Term, 1965
No. 418

A. J. BUMB, as Trustee in Bankruptcy of United States Chemical Milling Corporation,

Petitioner,

vs.

THE HARTWELL CORPORATION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

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vs.

THE HARTWELL CORPORATION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

Petitioner A. J. Bumb, as trustee in bankruptcy of United States Chemical Milling Corporation, hereby requests that the Court issue a writ of certiorari to the United States Court of Appeals for the Ninth Circuit for the purpose of reviewing a judgment of that court adverse to petitioner.

I.

Opinion Below.

Neither the Referee in Bankruptcy before whom the present controversy was tried nor the District Judge who reviewed the Referee's decision wrote opinions. The opinion of the Court of Appeals is reported in 345 F. 2d 453, and a copy thereof is appended to this Petition.

II.

Jurisdiction.

The judgment of the Court of Appeals, a copy of which is appended hereto, was made and entered on May 5, 1965. Jursidiction to review that judgment by writ of certiorari is conferred upon this Court by 28 U.S.C. Sec. 1254(1). In addition, the judgment in question having arisen out of proceedings in bankruptcy, the Court is invested with jurisdiction by section 24(c) of the Bankruptcy Act (11 U.S.C. Sec. 47(c)).

III.

Questions Presented.

The issues presented to the Court arise out of a sale made by the petitioning trustee during the course of corporate reorganization proceedings pursuant to Chapter X of the Bankruptcy Act (11 U.S.C. Secs. 501-676). At the time of all events pertinent to the controversy, the debtor United States Chemical Milling Corporation was undergoing reorganization in the United States District Court for the Southern District of California, Central Division, and petitioner A. J. Bumb was its reorganization trustee. In June of 1963 the debtor was adjudicated a bankrupt and petitioner was then appointed and continues to serve as trustee in bankruptcy.

In October of 1962, petitioner, pursuant to court authority, entered into negotiations for the sale of an autonomous division of the debtor corporation which engaged in the production of latches. The ultimate purchaser of this division was respondent, The Hartwell Corporation.

In connection with soliciting bids for the latch division, petitioner engaged several former employees of

the debtor for the purpose of compiling data which he eventually transmitted to the prospective purchasers, including respondent. A clerical error occurred in the preparation of this information which resulted in a substantial overstatement of the "backlog", or amount of unfilled purchase orders which had been received for the products of the business. The erroneous backlog figure was relayed by petitioner to respondent.

The parties entered into a sales escrow on November 30, 1962. Pursuant to the contract of sale, respondent took possession of certain physical property involved in the sale on January 4, 1963, prior to consummation of the transaction. Immediately following this transfer of possession, a shortage in the amount of backlog became apparent. By January 18, 1963, the error had been discovered and the true backlog ascertained. Respondent, however, elected not to rescind the transaction because of the misstatement, and the escrow eventually closed on March 13, 1963.

Respondent subsequently obtained an order requiring petitioner to show cause before the Referee in Bankruptcy why he, as representative of the estate, should not be liable for damages equal to respondent's lost profits which it anticipated it would realize in filling the overstated backlog of orders. After trial of the issues, the Referee found generally for respondent and entered an order awarding damages, which he computed by means of a formula designed to arrive at the amount of profits which respondent would have enjoyed had the backlog been in the amount stated by petitioner.

The trustee successfully petitioned for a review of the Referee's decision by a Judge of the District Court, who,

after hearing, reversed the Referee's order and directed entry of judgment for petitioner.

The present respondent then filed notice of appeal to the Court of Appeals for the Ninth Circuit. That court agreed with the Referee on all points presented to it, reversed the District Court's order, and remanded with instructions to reinstate the judgment of the Referee.

Petitioner thus comes to this Court having been held liable on a theory of misrepresentation because of the error of an employee. Moreover, the damages awarded to respondent represent lost anticipated profits, calculated without reference to the value of the assets which it acquired or the price which it paid for them. We submit that both of these results are erroneous and that they present for decision the following significant questions:

1. May a reorganization trustee be liable in a deceit action for a statement made by him in reliance upon information obtained from responsible employees of the debtor, the accuracy of which information he believed and had no reason to doubt?

2. If, by reason of the manner in which the litigation arose, a federal court is called upon to determine a claim founded in state law, may it refuse to apply the established state law of damages?

3. May the federal court in such a situation also refuse to apply the law of damages established by the federal courts in cases arising under statutes of the United States?

4. May damages be recovered on a theory of misrepresentation when the true facts are discovered sufficiently prior to the consummation of the transaction to permit the complaining party to withdraw?

IV.

Statutes Involved.

While much of the law applicable to the issues is to be found in the decisions of the federal and California state courts, two statutes are directly involved. They are:

1. The Rules of Decision Act, 28 U.S.C. Sec. 1652:

   "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

2. California Civil Code Sec. 3343:

   "One defrauded in the purchase, sale or exchange of property is entitled to recover the difference between the actual value of that with which the defrauded person parted and the actual value of that which he received, together with any additional damage arising from the particular transaction.

   "Nothing herein contained shall be deemed to deny to any person having a cause of action for fraud or deceit any legal or equitable remedies to which such person may be entitled."

V.

Statement of the Case.

Shortly after his appointment as the reorganization trustee of a publicly-held corporation which employed several hundred persons and made sales of millions of dollars annually, petitioner took steps to inform himself as to the nature and extent of the estate entrusted to

him. He could not reasonably have been expected to accumulate personally the information from which he could analyze the condition of the debtor and evaluate its prospects.

For the purpose of preparing the data which he subsequently transmitted to respondent, and which included the erroneous backlog figure, petitioner retained what one witness termed "a nucleus of key employees" of the debtor corporation. In fact, petitioner employed the person who committed the error upon the recommendation of the debtor's personnel manager, who informed petitioner that this person was the employee most familiar with the information being compiled. Undisputed evidence established that this was the normal and usual practice of bankruptcy administrators in dealing with estates of this size.

The error was a simple and understandable one; while preparing summaries for petitioner, the clerical employee transposed the backlog figure for the latch division with the corresponding number for another division of the debtor. There has never been any contention that this was anything other than an honest mistake or that petitioner did not rely upon the data provided to him and accept it as accurate. It is solely on the basis of his relaying this inaccurate figure to respondent that petitioner has been found liable for the tort of deceit.

In presenting to the Referee in Bankruptcy its application for damages allegedly arising out of this misstatement, respondent invoked the jurisdiction conferred upon the District Court by 28 U.S.C. Sections 84(b)(2) and 1334. The Court of Appeals also found juris-

diction in the District Court under 28 U.S.C. Section 1331.

In its pleadings and proof before the Referee, respondent asserted the theory that damages for the alleged misrepresentation should be calculated on the basis of the profits which it would have realized in filling purchase orders in an amount equal to the difference between the actual backlog and the backlog as stated by petitioner. The Referee and the Court of Appeals accepted this theory. The formula by which damages were computed is set forth in footnote 1 on page 3 of the opinion of the Court of Appeals, Appendix "A" hereto.

Throughout the proceedings, petitioner has contended that the proper and exclusive measure of damages is the so-called "out-of-pocket" rule embodied in California Civil Code Section 3343, quoted above. Consistent with his position, petitioner adduced evidence of the value of the business acquired by respondent, and the amount of the consideration paid by respondent. This evidence, we submit, established that respondent received greater value in the transaction than it gave. However, the Referee, having adopted the lost profits or "benefit of the bargain" approach to damages, made no Findings of Fact with respect to the value of the business or the amount paid for it.

Petitioner and respondent are, respectively, a California citizen and a California corporation having its principal place of business in California. At all stages of these proceedings, the parties have briefed and argued the case on the basis of California law, although petitioner has always pointed out that federal decisional

law on the question of damages is identical to that of California. Respondent originally contended that the rule of Civil Code Section 3343 is not the exclusive measure of damages in California. Upon appeal, it apparently abandoned this argument and asserted instead that there was support in the record for an award of damages under the out-of-pocket rule. Petitioner has consistently contended that this measure of damages is exclusive.

As may be seen from its opinion at pages 6 and 7, the Court of Appeals disagreed with the positions taken before it by both parties. While recognizing that the out-of-pocket approach "is the general rule adopted by Section 3343 of the California Civil Code", the Court refused to accept it as exclusive. Rather, the Court adopted, by name, the "benefit of the bargain" measure of damages, and confirmed the Referee's awarding of expected profits as damages.

VI.

Reasons for Granting the Writ.

The foregoing summary of the present litigation indicates that a federal reorganization trustee has been found liable in a deceit action because of the error of an employee. It further reveals that the Court of Appeals for the Ninth Circuit, in an essentially state action, has refused to apply well-established state law. Moreover, the Court of Appeals, in departing from state law, also failed to apply the substantive law established by the courts of the United States in controversies arising under federal statutes. This, we submit, constitutes the Court of Appeals' opinion as an anomolous precedent and one which should be reviewed by this Court.

1. Turning first to the issue concerning determination of the applicable law, it is to be noted that the Court of Appeals did not attempt to couch its decision in terms of the law of California. Forthright and frankly, the court disagreed with the California statute on the measure of damages and refused to apply it. An important question of choice of law in the federal courts is thus presented.

There can be no doubt that the out-of-pocket rule embodied in California Civil Code Sec. 3343 is the exclusive measure of damages in that state. The California Supreme Court has so held, thus putting to rest a dispute over that question which had previously existed. *Gagne v. Bertram,* 43 Cal. 2d 481, 275 P. 2d 15 (1954); *Bagdasarian v. Gragnon,* 31 Cal. 2d 744, 192 P. 2d 935 (1948).

Before the trial court, respondent argued that the cases of *Ward v. Taggart,* 51 Cal. 2d 736, 336 P. 2d 534 (1959), and *Coleman v. Ladd Ford Co.,* 215 Cal. App. 2d 90, 29 Cal. Rptr. 832 (1963), had altered this rule of exclusivity. Petitioner pointed out that the California court had found a special basis for recovery in *Ward v. Taggart:* The violation by defendant, a licensed real estate broker, of his statutory duty "to be honest and truthful in his dealings". For breach of this duty, the defendant was held as a constructive trustee of the "secret profit" he made in the transaction. (51 Cal. 2d at 741-742.) Such a theory has no application to the instant case. As noted at page 741 of the *Ward* opinion, "in the absence of a fiduciary relationship, recovery in a tort action for fraud is limited to the actual damages suffered by the plaintiff."

This special basis was recognized in *Coleman v. Ladd Ford Co.*, where the court interprets *Ward v. Taggart* as relaxing the out-of-pocket rule where the evidence shows

> "a combination of constructive trust—unjust enrichment and quasi-contractual relationships which will support an award of exemplary damages in addition to permitting recovery under the 'loss of bargain' rule." (215 Cal. App. 2d at 93.)

It did not take long for the California courts to dispel any notions that the *Ward* and *Coleman* cases had changed the law applicable to ordinary deceit actions. In *McCauley v. Dennis*, 220 Cal. App. 2d 627, 34 Cal. Rptr. 90 (1963), the court pointed out that the out-of-pocket rule obtains in the absence of the special factors found in *Ward*. Also to be noted is *Gulke v. Brock*, 222 Cal. App. 2d 459, 35 Cal. Rptr. 200 (1963), a subsequent decision by the same panel of the District Court of Appeal which decided *Coleman v. Ladd Ford Co.* In it the court holds without discussion that the out-of-pocket rule is the proper measure of damages in cases of this nature.

In any event, and as pointed out above, respondent did not advance this argument before the appellate court, and that court made no attempt to bring this case within the *Ward* or *Coleman* decisions. Thus, the question is squarely raised "whether the federal court was free to disregard the alleged rule of the (state law)." *Cf. Erie R. Co. v. Tompkins*, 304 U.S. 64, 66 (1938).

Under the Rules of Decision Act, 28 U.S.C. Sec. 1652, state law, where it is applicable, constitutes the governing law in federal court actions, unless the Con-

stitution, treaties or statutes of the United States otherwise require. It is clear that state law is generally applicable on the question of the measure of damages. *Toho Bussan Kaisha, Ltd. v. American President Lines,* 265 F. 2d 418 (2d Cir. 1959); *Shepard v. Cal-Nine Farms,* 252 F. 2d 884 (9th Cir.), *cert. denied* 356 U.S. 951 (1958) (Arizona law; "benefit of the bargain" rule applied); *Stone v. Farnell,* 239 F. 2d 750 (9th Cir. 1956) (California law; "out-of-pocket" rule of Civil Code Sec. 3343 applied); *Thompson v. American Power & Light Co.,* 192 F. 2d 651 (5th Cir.), *cert. denied* 342 U.S. 954 (1952).

Federal jurisdiction in all of the above cases was apparently based upon diversity of citizenship, and the choice of state law was dictated by the decision of this Court in *Erie R. Co. v. Tompkins.*

In the present case, an essentially California controversy was heard by the federal courts because it arose out of a bankruptcy proceeding. The effect of the ground for federal jurisdiction upon the federal court's choice of substantive law is thus presented for consideration; that is, whether the fact that a federal statute forms the basis for jurisdiction makes the case one which is to be determined by federal substantive law.

It is generally accepted that the "source of the right", and not the ground upon which federal jurisdiction is invoked, determines the law applicable to a claim. *Maternally Yours v. Your Maternity Shop,* 234 F. 2d 538, 540 n. 1 (2d Cir. 1956); 1A Moore, *Federal Practice,* 3054-55 (2 ed. 1965); Hill, "The Erie Doctrine in Bankruptcy", 66 Harv. L. Rev. 1013, 1033

(1953). However, as is noted in the *Maternally Yours* case, this is not a universally accepted principle.

The Court of Appeals for the Second Circuit there felt compelled to preface its opinion with a lengthy footnote discussing the choice of law problem presented when a federal court, exercising its pendent jurisdiction, determines a common law claim for unfair competition. The court took the position that the source of the right and not the ground for federal jurisdiction indicates the governing law, "despite repeated statements implying the contrary." Judge Clark was sufficiently concerned with the importance of the question to prepare a concurring opinion in which he stressed the choice of law problem.

It must be conceded that federal substantive law can be controlling on the question of the measure of damages. This is well illustrated by *Estate Counselling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F. 2d 527 (10th Cir. 1962). There, the court applied state law to a common law cause of action for fraud, and federal decisional law to a claim based upon the Securities Exchange Act of 1934.

However, this case in fact supports the proposition that the nature of the claim, and not the fact that it is asserted in a federal court, determines the governing law. Thus, the measure of damages established by the state courts was applied to the fraud cause of action, while the measure established by the federal courts was applied to the cause of action founded on the federal statute.

The foregoing authorities indicate that the California law of damages should have been applied in the instant

case. Moreover, this Court has held, although without a definitive discussion of the question, that state law governs in suits by bankruptcy trustees where state-created rights are asserted. *Harrigan v. Bergdoll*, 270 U.S. 560 (1926). See also *National Mutual Ins. Co. v. Tidewater Transfer Co.*, 337 U.S. 582, 598-99 (1949).

It is true that federal substantive law is often applied in suits arising out of bankruptcy proceedings. See, *e.g.*, *Prudence Corp. v. Geist*, 316 U.S. 89 (1942). We submit, however, that a distinction must be drawn between cases in which federal bankruptcy policy is involved and those which are decided by federal courts only because they arose out of proceedings in bankruptcy. In the latter class of cases, of which the instant controversy is typical, there is no federal policy to be served and no provision of the Bankruptcy Act requires the application of federal law. *Cf. Bumb v. United States*, 276 F. 2d 729 (9th Cir. 1960). Such cases are, rather, strictly state controversies, and they should be determined in accordance with state law. See Hill, "The Erie Doctrine in Bankruptcy", 66 Harv. L. Rev. 1013, 1036, 1050 (1953).

In refusing to apply California's statutory measure of damages in the instant case, the Court of Appeals has created a precedent which is in direct conflict with the decisions of the California courts. Moreover, it is at variance with the choice of law rules adopted by this Court and by numerous Courts of Appeal in similar cases. Such a decision, we submit, requires review by the Supreme Court.

2. Even assuming the Court of Appeals was free to disregard the California law, the question remains as to

whether it was required to follow any other established body of law.

The opinion of the Court of Appeals gives no indication of the specific source of the "benefit of the bargain" rule which the court chose to apply. It notes only that "many courts have recognized this approach". One thing is certain: The federal courts, in deciding claims arising under federal statutes, are not among those courts.

Where federal substantive law controls the measure of damages in actions of this nature, the courts have consistently applied the out-of-pocket rule. See *Sigafus v. Porter,* 179 U.S. 116 (1900); *Estate Counselling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 303 F. 2d 527, 532-33 (10th Cir. 1962).

It thus appears that the Court of Appeals followed neither California nor federal law in reaching its decision. Rather, it applied to an action between two California parties brought in California the substantive law of some other, unnamed state.

Again it can be seen that the judgment below is contrary to the decisions of this Court and the other Courts of Appeal. The principle of uniformity of decisions would alone indicate that a review by this Court is in order.

3. With respect to the basis for petitioner's liability, a policy question of considerable practical importance in the administration of the Bankruptcy Act is presented.

To reiterate, a federal reorganization trustee has been found liable in a deceit action for transmitting erroneous information furnished to him by qualified

former employees of the debtor. No evidence was produced and no Finding was made to the effect that petitioner did not exercise all reasonable care in selecting his empolyees and familiarizing himself with the estate. Rather, he has been held liable for no reason other than because a mistake was made. In short, a standard of absolute liability for misrepresentation has been imposed. This, we submit, is an unreasonable and undesirable standard to impose upon those who administer bankrupt estates.

It must be borne in mind that respondent's claim was not one for ordinary negligence. Although sometimes denominated "negligent misrepresentation", the tort encompasses an element of intent, traditionally termed "scienter". It is true that an actual fraudulent intent is not required for liability; however, a lack of care or recklessness sufficiently reprehensible to be equated with intent to defraud must be shown. See generally Keeton, "Fraud: The Necessity for an Intent to Deceive", 5 U.C.L.A. L. Rev. 583 (1958).

The tort is not negligence, but deceit. The question is not whether an error was made in the compilation of certain information, but whether petitioner was justified, on the basis of the facts available to him, in transmitting that information to respondent.

We submit that it is not sufficient to base liability upon the fact that an employee of petitioner may have been negligent. Again, the cause of action did not arise because an error was made, but because petitioner made a statement to respondent. If liability is to be imposed, it must be upon the ground that petitioner was not justified in relying upon the information available to him when he made that statement.

We have found no precedent for the decision in question. When applied to a bankruptcy administrator, it is an unwise decision which, if allowed to stand, could well impede the efficient and expeditious administration of estates.

Effective administration of insolvent estates demands their prompt evaluation and liquidation. If creditors are to realize the maximum recovery, the trustee must analyze his position and negotiate his transactions before the debtor ceases to be a going business. If he does not, he will find himself attempting to dispose of a collection of assets which have lost their value as an operating business.

If the present decision is permitted to establish a standard, trustees may well hesitate before attempting to move with the alacrity required to obtain maximum value. Faced with a standard of strict liability for any misstatement as to the nature or extent of the estate, the trustee could be expected to proceed with caution in evaluating and disposing of his wares. While as a general principle caution is no doubt desirable, it could be quite expensive to the creditors when exercised in abundance in a setting of insolvency.

We of course do not advocate *carte blanche* for bankruptcy administrators in the field of misrepresentation. We do propose that absolute liability is equally undesirable. If a trustee or receiver is to be found liable, it should be on the basis that he has failed to exercise reasonable care in the manner in which he acquired the data concerning the estate. Where, as here, the trustee acted with all due care and reasonably relied upon the information supplied to him, there is no foundation for liability.

4. Respondent has been awarded damages because of an alleged misrepresentation, although the true facts were known to all parties prior to the consummation of the transaction. This result, we suggest, does violence to the universally accepted proposition that reliance upon a misrepresentation must be shown if there is to be a recovery. Moreover, it is a result directly contrary to several California decisions. *Thomas v. Birch,* 178 Cal. 483, 490, 173 Pac. 1102 (1918); *Nounnan v. Sutter County Land Co.,* 81 Cal. 1, 22 Pac. 515 (1889); *Gratz v. Schuler,* 25 Cal. App. 117, 142 Pac. 899 (1914).

Concededly, however, this is a question of state law with which this Court is no doubt unconcerned at the present stage of these proceedings. Accordingly, we shall defer further discussion of it until such time as the entire case may be before the Court.

VII.

Conclusion.

A significant question of bankruptcy policy was presented to the court below and was, we submit, erroneously determined. Moreover, the Court of Appeals departed from accepted choice of law principles with the result that neither California nor federal substantive law was applied to a dispute heard in a federal court sitting in California. This Court should issue certiorari for the purpose of reviewing that decision.

Respectfully submitted,

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July 29, 1965.

APPENDIX A.

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

The Hartwell Corporation, Appellant, vs. A. J. Bumb Trustee, etc., Appellee. No. 19,642.

[May 5, 1965]

Appeal from the United States District Court for the Southern District of California Central Division.

Before: Barnes and Koelsch, Circuit Judges; and Powell, District Judge

Barnes, Circuit Judge:

This is an appeal from a district court order reversing a decision of a referee in bankruptcy. Jurisdiction over this bankruptcy matter was conferred upon the district court by 28 U.S.C. §§84(b)(2), 1331 and 1334. We have jurisdiction to entertain this appeal from the district court's final order pursuant to 11 U.S.C. § 47 and 28 U.S.C. § 1291.

The district court order does not particularize the gounds upon which it reversed the referee's decision. We can only infer from the summary approach that the district court accepted the findings of fact of the referee but found the decision reached incorrect as a matter of law.

The undisputed findings of fact of the referee state that this controversy involves a suit against the trustee in bankruptcy for the United States Chemical Milling

Corporation for damages sustained as the result of misrepresentation and breach of warranty. In the course of the bankruptcy proceedings, the trustee sought to sell an autonomous division of the bankrupt, "Missile-Air Latch Division." The trustee solicited an offer from appellant in the course of which he made a written represenatation that "backlog in this division as of August 31, 1962, was for the gross sum of $60,872.00." (Appellant's Ex. 1.) Relying in part upon this backlog representation, appellant submitted an offer to purchase the division.

The statement regarding the backlogged orders was undeniably false. The actual backlog as of August 31, 1962, as determined by the referee, was $22,152.00. The error resulted from the careless preparation of data by an employee of the bankrupt.

The trustee accepted appellant's offer on November 30, 1962. It was not until on or about January 18, 1963, that appellant first learned of the misrepresentation regarding backlog. By this date, however, appellant had already entered into an escrow agreement with the trustee and had deposited $45,000.00 pursuant to the escrow instructions, and had taken possession of a substantial portion of the physical assets of the purchased division. Upon learning of the error in the statement of backlog of orders, appellant notified appellee that it wished to complete performance of the contract but that in so doing, it did not intend to waive its claim for damages. The conditions of the escrow were subsequently fulfilled and the duties of the parties were discharged. Appellant then sought reimbursement for the damages it purportedly sustained.

The referee concluded that the trustee had negligently misrepresented the amount of the backlog. As a result of this negligent misrepresentation, the referee concluded that appellant had sustained damages in the amount of $14,579.06.[1]

The district court found that the referee had erred in granting judgment against the trustee, and entered an order reversing that judgment. The district court gave no reasons for its action. We find that no legal basis exists to sustain this reversal.

The evidence and the findings support the referee's conclusion that appellee was guilty of negligent misrepresentation. The tort of negligent misrepresentation does not require that the person making the statement be aware of its untruth. This tort was developed to protect a purchaser injured by a misrepresentation even in the absence of an intent to deceive on the seller's part. Thus, California Civil Code § 1572 recognizes a cause of action for misrepresentation where no intent to deceive is alleged. It defines actual fraud as:

> "2. The positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true. . . ."

---

[1]This amount was arrived at in the following manner:

1. The difference between the actual backlog and the misstated backlog was $38,720.00 ($60,872.00 less $22,152.00.)

2. Twenty per cent of the backlog was deducted as an estimate of what would have been cancelled under the normal attrition rates. (20% of $60,872.00 equals $12,174.00.) This left a gross profit of $26,546.00. ($38,720.00 less $12,174.00.)

3. The net profit before federal income taxes was calculated by applying the company's normal rate of return to the gross income. ($26,546.00 multiplied by 54.92%.) The loss in profits was thus determined to be $14,579.06.

California Civil Code § 1573 also makes it clear that deceit is not a necessary element of an action at law for misrepresentation:

> "Constructive fraud consists:
>
> "1. In any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or anyone claiming under him, by misleading another to his prejudice, or to the prejudice of anyone claiming under him; or
>
> "2. In any such act or omission as the law specially declares to be fraudulent, without respect to actual fraud."

See also *Clar v. Board of Trade,* 162 Cal.App.2d 636, 331 P.2d 89 (1958).

The findings of the referee, supported by undisputed evidence, conclude that "[t]he erroneous statement as to the amount of said backlog in the said letter of October 22, 1962, was the result of carelessness and negligence on the part of an employee, or employees of Respondent, in obtaining information as to the amount of backlog in each of the Bankrupt's divisions. This information was obtained at Respondent's request, and Respondent made no effort to verify the information so received." (Tr. p. 66.) We therefore reject appellee's contention that he cannot be held liable because he had a reasonable basis for his representation and because the representation was in accord with his information.

The referee found that appellant's reliance was justified. We find sufficient evidence in the record to support this finding. The evidence is ambiguous as to whether or not the trustee informed appellant that he could not confirm the amount of the backlog of orders.

But even if the record could support the contention that such a statement was made, no evidence can be found to support the argument that appellee sufficiently forewarned appellant so that appellant should have conducted an independent investigation. The trustee did little more than inform appellant that the backlog figure was based upon the calculations of an employee of the bankrupt. Nothing the trustee said could be utilized to support a characterization of appellant's reliance on the backlog figure as unjustified.

Appellee also contends that appellant *waived* its objections, *i.e.*, that appellant's reliance was unjustified because, upon learning of the misrepresentation, appellant chose to proceed with the performance of the contract rather than to seek immediate rescission. This contention is contrary to the law and sound reasoning. To encourage the expedient flow of commercial goods, contemporary commercial law seeks to encourage the fulfillment of contractual obligations with monetary adjustments for minor variances. The philosophy of the new Uniform Commercial Code is to this effect. And the California case law, even prior to the adoption of the Uniform Commercial Code in California, has long recognized that one can affirm a contract and then sue for damages resulting from misrepresentations during the contract negotiations. *Harold v. Pugh,* 174 Cal.App. 2d 603, 610 (1959); *Squire's Dept. Store, Inc. v. Dudum,* 115 Cal.App.2d 320, 323 (1953); *Bagdasarian v. Gragnon,* 31 Cal.2d 744, 750 (1948). We find that appellant's affirmance of the contract does not make its reliance unjustified, nor preclude it from recovering for the damages sustained as a result of the misrepresentation.

The district court order to reverse made no mention of the propriety of the method used by the referee to calculate the measure of appellant's damages. Appellee, in his brief, argues at great length that the damage calculation was incorrect, and that appellant in fact sustained no injuries from the misrepresentation. Appellee urges that the only proper method of calculation is the so-called "out-of-pocket" approach, which compares the value of the detriment suffered by each party to the entire contract. Appellee contends that the value of that received by appellant, even using the actual backlog figure, exceeded the value of that given by appellant. Appellee reaches this conclusion by attempting to evaluate each element of consideration involved in the transaction.

We agree that in some instances the "out-of-pocket" approach is a correct measure of damages and has been properly used in a number of cases. It is the general rule adopted by § 3343 of the California Civil Code. But we cannot blindly adhere to this approach as the exclusive measure of damages. In the present case, the referee relied upon what is commonly referred to as the "benefit of the bargain rule," comparing the value of what was represented would be received to the value of what actually was received. The district court apparently did not object to this approach. Many courts have recognized this approach as a reasonable method of damage calculation. Under the circumstances presented in this case, we think it is reasonable to conclude that the "benefit of the bargain" approach would be the more accurate method of damage measurement for it would not entail a valuation of each element of the contractual consideration. The method used by the referee

merely had to compare two readily ascertainable figures, *viz.*, the actual backlog as of August 31, 1962, and the represented backlog as of that date. The method used is an accurate measurement of the damages sustained, and nothing in the district court order, the record of the bankruptcy proceedings, or the appellee's brief leads us to a contrary conclusion.

Since the district court has supplied no reason casting doubt on the accuracy or validity of the referee's calculations, we will abide by the referee's expert judgment as to the most appropriate measurement of damages, under the facts of this case.

We reverse the order of the district court, and remand with instructions to reinstate the judgment of the referee in bankruptcy.

APPENDIX B.

Judgment.

United States Court of Appeals for the Ninth Circuit.

The Hartwell Corporation, Appellant, vs. A. J. Bumb, Trustee, etc., Appellee. No. 19,642 (D.C. No. 144-766-TC).

Appeal from the United States District Court for the Southern District of California, Central Division.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Southern District of California, Central Division, and was duly submitted.

On Consideration Whereof, It is now here ordered and adjudged by this Court, and that the judgment of the said District Court in this Cause be, and hereby is reversed and be and hereby is remanded to the said District Court with instructions to reinstate the judgment of the referee in bankruptcy, with costs in this Court in favor of the appellant and against the appellee.

It is further Ordered and Adjudged by this Court that the appellant recover against the appellee for its costs herein expended and have execution therefor.

Costs:	
Docket fee	$25.00
Expense of printing record	63.20
Total Costs:	$88.20

A True Copy
Attest: June 16, 1965
/s/ Frank H. Schmid,
Frank H. Schmid, Clerk

Filed and entered May 5, 1965.

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IN THE

Supreme Court of the United States

October Term, 1965
No. .....

A. J. BUMB, as Trustee in Bankruptcy of United States Chemical Milling Corporation,

Petitioner,

vs.

THE HARTWELL CORPORATION,

Respondent.

Respondent's Brief in Opposition to Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

I.

Preliminary Statement.

The Hartwell Corporation, respondent in the Petition of A. J. Bumb, as Trustee in Bankruptcy for the United States Chemical Milling Corporation, for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, by this Brief replies to the Petition.

We agree that the Court of Appeals for the Ninth Circuit rendered the Opinion which is attached to the Petition as Appendix A, and that jurisdiction to consider the Petition is grounded as set forth in the Petition.

II.

Questions Presented.

Petitioner's presentation of the questions presented is argumentatively slanted in favor of petitioner's position and does not, we feel, contain an accurate statement of the questions presented.

Moreover, petitioner fails entirely to pose its list of "Questions Presented" by reference to, and in light of, Rule 19(1)(b), which sets forth the types of situations under which the Supreme Court will grant Certiorari.

A more accurate, we submit, statement of the single question here presented is as follows:

> "Should the Supreme Court of the United States grant a Petition for Certiorari to review a Decision of the Court of Appeals in a case which arose in a Bankruptcy proceeding, wherein the Trustee, in his official capacity, as Seller, made a material misrepresentation of fact to the Buyer, on which the Buyer relied in purchasing the property, and wherein the Referee in Bankruptcy awarded damages measured by loss of profit which would have been realized had the representation been true, which expected profit was one of the elements for which consideration was paid by the Buyer?"

III.

Statement of the Case.

Petitioner's statement of the case is also argumentatively slanted in favor of petitioner's position in several respects. We submit that the following brief statement is an accurate one:

Petitioner, in his official capacity as a Trustee in Bankruptcy, after having obtained Court permission authorizing him to do so, sought to sell, at private sale, a going business consisting of physical assets and goodwill known as the "Missile-Air Latch Division". The Trustee solicited offers from various parties, including respondent, The Hartwell Corporation, and, in so soliciting, represented that the "backlog of orders as to the Division amounted to $60,872.00." Respondent submitted an offer consisting of cash, assumption of royalty and other obligations, and a new obligation to pay royalty to the Trustee over a ten-year period. The Trustee accepted the offer, the transaction was placed in Escrow, and the physical transfer of the personal property was made to the respondent-buyer. In submitting the offer, in entering into the Escrow, and in taking possession of the physical property, respondent relied on the representation as to the backlog; and the backlog was part of that for which the respondent paid. At this point, it was discovered that the amount of the backlog had been misrepresented, but, without waiving its claim for damages, respondent completed the transaction, rendered the consideration to the Trustee-seller, and

sought relief before the Referee in Bankruptcy for its damages. After trial, the Referee made Findings of Fact, adopted Conclusions of Law, and rendered Judgment in favor of the respondent-buyer, awarding $14,579.06 to the respondent-buyer, payable out of the bankrupt estate (actually payable by offsetting the same against royalty in favor of the bankrupt estate then in the process of accruing).

The Trustee in Bankruptcy petitioned the District Court for review, and, in a four-line Order, the District Court purported to order the judgment of the Referee reversed.

On Appeal from this Order, the Court of Appeals for the Ninth Circuit reversed the Order of the District Court, and ordered the reinstatement of the Judgment of the Referee in Bankruptcy.

IV.

Reasons for Denial of the Writ.

As noted above, the petitioner has failed to identify clearly the justification for granting a Writ of Certiorari within the ground rules prescribed by Rule 19(1)(b), and the applicable case law. However, a process of elimination suggests the only possible applicable provision of this Rule which might conceivably justify the granting of this Writ.

It is not contended that the decision of the Court of Appeals is in conflict with the decision of any Court of Appeals on the same matter, justifying the granting of the Writ in the interests of achieving uniformity; it is not contended that the Court of Appeals has decided an important question of Federal law which has not been, but which should be, settled by the

Supreme Court; it is not suggested that the Court of Appeals has decided the Federal question in a way which is in conflict with an applicable decision of the Supreme Court of the United States, or has misconceived the maintaining of a "controlling" Supreme Court decision; nor is it suggested that the Court of Appeals has so far departed from the accepted and usual course of judicial proceedings, or has so far sanctioned such a departure by a local court, as to call for an application of the Supreme Court's power of supervision.

Obviously, the petitioner is contending that the Court of Appeals has decided "an important State question" in such a way as to conflict with applicable State law.

At the threshold, it must be determined whether or not there is involved here "an important State question". Unless it is, in fact, an important State question, no one can expect the Supreme Court of the United States to concern itself with the question.

The Findings of Fact of the Referee, as disclosed by only a cursory review of the record, foreclosed a review in the Court of Appeals, and forecloses a review by the Supreme Court, since they are plainly supported by competent evidence within the Federal Rule that they must be accepted unless "clearly erroneous". This also forecloses the contentions asserted by the petitioner here, and also asserted in the Court of Appeals, that a Trustee is not liable in a deceit action for a statement made by him in reliance upon information obtained from responsible employees of the debtor, the accuracy of which information he believed, and had no reason to doubt, and that damages may not be recovered on

the theory of misrepresentation when the true facts are discovered sufficiently prior to the consummation of the transaction to permit the complaining party to withdraw.

Petitioner, while advancing these arguments, is patently refusing to recognize that he is quarreling with factual determinations of the finding of fact which were made against him on competent evidence, and the obvious application of the doctrine of *respondeat superior,* and the doctrine that waiver is a question of fact and will never be found where a rescission could not restore the parties to *status quo.* In brief, while these points are urged, they actually involve factual determinations made against the petitioner, and no question of State law, important or otherwise, is involved.

Thus, the only possible question of State law involved is as to the measure of damages. We do not agree, as we shall point out in more detail *infra,* that the decision of the Court of Appeals was in any way in conflict with State law. But, even assuming, for the limited purpose of this discussion, that there is, or might have been, some conflict, it is manifest that it is not an important question of State law.

"Important" suggests that the question must be more than academic, and more than intellectually interesting; that it is special; that it is of serious concern to a substantial segment of the public, as distinguished from litigants themselves in the context of their peculiar factual situation, and a few others who might find themselves involved in similar factual situations. Tested by these rules, the question of measure of damages, in the limited factual situation involved in this case, is manifestly not special and not important.

But, even assuming that there is here involved a "special and important question of State law, the next inquiry is whether or not the Court of Appeals has decided it in such a way that it is in conflict with applicable State law. We submit that, as we shall demonstrate in the next section of this Brief, the Court of Appeals did not decide a State law question in conflict with applicable State law, and that the Petition should, therefore, be denied.

V.

The Decision of the Court of Appeals Is Not in Conflict With Applicable State Law.

Respondent accurately quotes *California Civil Code* §3343, which reads as follows:

> "[*Damages for fraud in the purchase, sale or exchange of property.*] One defrauded in the purchase, sale or exchange of property is entitled to recover the difference between the actual value of that with which the defrauded person parted and the actual value of that which he received, together with any additional damage arising from the particular transaction.
>
> "Nothing herein contained shall be deemed to deny to any person having a cause of action for fraud or deceit any legal or equitable remedies to which such person may be entitled."

The Court of Appeals clearly did not ignore this statute. It said:

> "We agree that in some instances the 'out-of-pocket' approach is a correct measure of damages and has been properly used in a number of cases. It is the general rule adopted by §3343 of the Cali-

fornia Civil Code. But we cannot blindly adhere to this approach as the exclusive measure of damages. In the present case, the referee relied upon what is commonly referred to as the 'benefit of the bargain rule,' comparing the value of what was represented would be received to the value of what actually was received. The district court apparently did not object to this approach. Many courts have recognized this approach as a reasonable method of damage calculation. Under the circumstances presented in this case, we think it is reasonable to conclude that the 'benefit of the bargain' approach would be the more accurate method of damage measurement for it would not entail a valuation of each element of the contractual consideration. The method used by the referee merely had to compare two readily ascertainable figures, *viz.,* the actual backlog as of August 31, 1962, and the represented backlog as of that date. The method used is an accurate measurement of the damages sustained, and nothing in the district court order, the record of the bankruptcy proceedings, or the appellee's brief leads us to a contrary conclusion."

The petitioner apparently would have this Court believe that the general rule enunciated in Section 3343 of the California Civil Code is so inflexible that *any* Judgment which departs from a comparison of the actual value of that which the defrauded person parted with and the actual value of that which he received, in the *context of the entire contract,* is erroneous. Such is clearly not the case under California law; the statute itself does not so state, and the California courts have concededly departed from such an inflexible rule where

the circumstances of a particular case called for such departure. (See e.g., *Ward v. Taggart* (1959), 51 Cal. 2d 736, 741-742; *Coleman v. Ladd Ford Co.* (1963), 215 Cal. App. 2d 90, 93-94. See also: 11 University of California at Los Angeles Law Review (1964), pp. 876-884.)

Actually, that which the Court of Appeals said briefly may be paraphrased and expanded to reflect this: The buyer bought a business consisting of a number of component parts, namely, machinery, inventory of parts, drawings, specifications, backlog of orders, and good will. There being no evidence to the contrary, it must be assumed that the buyer paid a fair market value for what it bought, and what it was represented by the seller that it was buying, including a backlog of orders in a certain amount. When the backlog turned out to be substantially less than it had been represented to have been, and when, through arithmetical computation, based upon competent and undisputed evidence, it was possible to measure the dollar and cents value of the backlog as it actually existed, as compared with that which was represented, then it follows that the buyer has been damaged in a measurable amount of money, that, actually, the buyer must be deemed to have paid for the segment of the property, consisting of backlog, the amount which the backlog would have been so measurably worth had it been in existence, and that which the buyer paid for that backlog was in excess of that value by the measurable amount of the non-existent portion of the backlog. That which petitioner seeks to read into the decision of the Court of Appeals is that the Court of Appeals, by the language which it used, affirmatively held

that the buyer, viewing the contract as a whole, got greater value for the total consideration with which it parted. The Court of Appeals' decision contains no such holding; respondent, before the Referee, obtained no such Finding of Fact, and certainly none is made or suggested by the brief Order of the District Court. The most that can be said is that respondent, before the Referee, presented evidence, and made argument thereon, which the Referee did not accept. In any event, that the Court of Appeals did not consider its decision to be grounded upon any such holding is demonstrated by the paragraph immediately preceding the one quoted above. The Court of Appeals says:

> ". . . Appellee, in his brief, argues at great length that the damage calculation was incorrect, and that appellant in fact sustained no injuries from the misrepresentation. Appellee urges that the only proper method of calculation is the so-called 'out-of-pocket' approach, which compares the value of the detriment suffered by each party to the entire contract. Appellee contends that the value of that received by appellant, even using the actual backlog figure, exceeded the value of that given by appellant. Appellee reaches this conclusion by attempting to evaluate each element of consideration involved in the transaction."

When viewed in the light of the Findings of Fact of the Referee, and in the light of the trial record, it is manifest that neither the Referee, the District Court, nor the Court of Appeals considered the argument of the petitioner that respondent received greater value under the entire Contract to have merit; on the contrary, the record contains substantial evidence that,

viewing the Contract as a whole, respondent received property the value of which was less than the consideration which it paid, to the extent of the missing backlog.

It seems clear that the Court of Appeals' reference to the "out-of-pocket" rule should be considered as saying that, even if the facts might justify its application, it could and should be departed from under peculiar facts providing a more readily ascertainable and more equitable means of determining the dollar amount of damages. Such a departure is clearly sanctioned under California law. (*Ward v. Taggart, supra,* 51 Cal. 2d 736, 741-742; *Coleman v. Ladd Ford Co., supra,* 215 Cal. App. 2d 90, 93-94; 11 University of California at Los Angeles Law Review (1964), pp. 876-884.)

It is respectfully submitted that the decision of the Court of Appeals is not ". . . in conflict with applicable state . . . law . . .", and, therefore, that this Court should deny the within Petition.

Respectfully submitted,

FORSTER, GEMMILL & FARMER,
By JOHN G. GEMMILL,
Attorneys for Respondent.